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SUBJECT: Serbia: Markets React to a Roller-Coaster Political  
Environment

Ref: Belgrade 155

Summary

1. Following President Tadic's reelection February 3, the primary Belgrade Stock Exchange index rose by 6.34% on February 4, but then returned to its long-term downward trends after PM Kostunica refused to discuss signing a political agreement with the EU. The dinar exchange rate followed the same path, with the dinar strengthening after the election but then sharply declining by 5% on February 7, forcing the National Bank (NBS) to intervene. Serbian markets are sending clear messages about the market view of positive (profitable) political developments and negative (loss-making) political developments. End Summary.

Post-Election Stock Exchange Jumps, Then Falls

2. On February 4, a day after Tadic's reelection, the Belgrade Stock Exchange (BSE) blue chip shares index BELEX 15 rose 6.34%, its second largest one day gain. Investors demonstrated relief in Tadic's victory. However, already on February 5, political uncertainty hit the market after Prime Minister Kostunica's negative comments on the EU movement toward launching a security and law enforcement mission in Kosovo. As the government paralysis continued throughout the week, the BELEX 15 slid further -- down by 4.17%, 4.25% and 1.34% from February 5-7 respectively, annulling the initial post-election gains. The BELEX 15 regained 1.1% on February 8, following the government decision on the sale of RTB Bor (septel) and after President Tadic made a statement saying he would schedule to meet with PM Kostunica in order to calm the political situation.

Central Bank Increased Bank Lending Rate By 0.75%

3. NBS Governor Jelasic announced on February 6 that the NBS had increased the primary bank interest rate from 10% to 10.75% in order to suppress growing inflation and to ease pressure on the dinar. Jelasic said that the economic situation in Serbia was deteriorating with accelerating inflation, growing current account deficit and slowing GDP growth.

Dinar First Strengthens then Falls, NBS Intervenes

4. Similar to the stock exchange results, the dinar appreciated post-reelection by 1.8%, reaching 81.44 dinars/euro. However, in the next few days, the dinar began sliding, even with increased interest rates, until the morning of February 7 when the drop sharpened to 5% in one day, reaching 85.5 dinars/euro. The NBS intervened to prevent further devaluation and sold \$29 million in

reserves to stabilize the currency at 83 dinars/euro. These flows highlighted Jelasic's February 4 warning that the "foreign exchange market is highly sensitive to political risks and in the short run the stability of the forex market depends on participants' expectations regarding political stability and macroeconomic trends."

Comment

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15. The recent events demonstrate the vulnerability of the Serbian economy and the need for political stability and predictability. The markets' movements are also an indicator of the potential economic cost of slowing Serbia's advance toward the EU. So far the effects of this week's political instability have been felt only in the markets. In our discussions with current and potential U.S. investors none of them have changed their plans in Serbia, but they have expressed concern that the current political paralysis must be resolved soon. End Comment.

MUNTER